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Department of the Treasury

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Person To Contact:

, ID No.

Telephone Number:

Refer Reply To:

CC:ITA:B07

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Date:

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Legend

Fund	=	
<u>X</u>	=	
States' Counsel	=	
Court	=	
<u>W</u>	=	
Product a		
<u>L</u>	=	
Date a	=	
Date b	=	
Date c	=	
Date f	=	
Date g	=	
Date h	=	
Date i	=	
Date j	=	
Date k	=	
\$x	=	
y%	=	

z%	=	
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Dear :

This responds to your letter requesting certain rulings concerning the application of § 468B of the Internal Revenue Code to the Fund. In particular, you requested rulings addressing the following issues:

1. Is the Fund is a qualified settlement fund under § 1.468B-1 of the Income Tax Regulations?
2. Does the Fund's modified gross income include prejudgment interest?
3. Is the Fund is allowed a deduction from its modified gross income for costs of States' Counsel, the administrator of the Fund (X), and the Special Master?
4. Is the Fund allowed a deduction from its modified gross income for Class Counsel Interest?
5. Is the Fund allowed a deduction from its modified gross income for the Additional Amount?
6. Does the Fund have a reporting obligation under § 6041 to class members for attorneys' fees, costs and expenses, and Class Counsel Interest awarded by the Court to class counsel?
7. Does the Fund have a reporting obligation under § 6041 to class members other than class representatives for incentive payment awards made to class representatives?
8. Does the Fund have a reporting obligation under § 6041 to class members for payments to class members that are allocable to compensatory damages or for payments made to class representatives that are allocable to an incentive award?

HOLDINGS

1. The Fund is a qualified settlement fund under § 1.468B-1.

2. The Fund's modified gross income does not include prejudgment interest.
3. The Fund is allowed a deduction from its modified gross income for costs of X and the Special Master to the extent such costs are deductible under chapter 1 of the Code in determining the taxable income of a corporation. However, the Fund is not allowed a deduction for the costs of States' Counsel.
4. The Fund is not allowed a deduction from its modified gross income for Class Counsel Interest.
5. The Fund is not allowed a deduction from its modified gross income for the Additional Amount.
6. The Fund does not have a reporting obligation under § 6041 to class members for attorneys' fees, costs and expenses, and Class Counsel Interest awarded by the Court to class counsel.
7. The Fund does not have a reporting obligation under § 6041 to class members other than class representatives for incentive payment awards made to class representatives.
8. The Fund does not have a reporting obligation under § 6041 (a) to class members for payments to class members that are allocable to compensatory damages, or (b) to class representatives for incentive payment awards.

FACTS

W is a corporation engaged in the production and distribution of Product a. In Date a, a group of W's customers filed a class action complaint with the Court alleging that W had breached its contractual obligations by failing to set the open price term in its sales contracts in good faith. An opt-out class action was certified by the Court in Date b. During the course of the litigation various individual States sought to become class members to be paid in their own right. In Date c, a jury returned a verdict in favor of the class finding that W had breached its contractual obligations to its customers.

On Date f, W entered into a Settlement Agreement with the class under which it agreed to pay \$x to the Fund to resolve all claims arising out of the litigation discussed above. On Date g, the Court entered its final approval of the Settlement Agreement and retained jurisdiction over the settlement administration process. On Date h, the Court appointed X as the administrator of the Fund. On Date i, W transferred \$x to the Fund, releasing W from further liability relating to the litigation and ending its participation in the claims administration process.

According to the terms of the Settlement Agreement, the Fund is designed to pay compensatory damages to the claimants for W's alleged breach of contract, prejudgment interest to the claimants (which ceased to accrue on Date j), incentive awards to class representatives, and class counsels' attorneys' fees, court costs, and other expenses. Any amounts remaining in the Fund after payment of all claims and expenses described above will be distributed pro rata to various individual States, who will hold such funds pursuant to applicable state unclaimed property laws to allow potential claimants who did not file a claim during the claims administration process to seek recovery from the individual States.

The Settlement Agreement also provided for the appointment of a Special Master and States' Counsels. The role of the Special Master is to impartially review and adjudicate each claim presented by class counsel for final resolution and payment from the Fund. States' Counsel was selected by the States to participate in the claims administration process on behalf of the collective interests of the interested State governments. States' counsel has standing to object to claims, assist in the resolution of conflicting claims, and facilitate the settlement of disputed claims.

On Date k, the Court ordered that all but one law firm, L, should be discharged from future representation of the class. The Court further ruled that the Fund pay L one-half of its court-ordered attorneys' fees at the beginning of the claims administration process, and pay the remaining half at the end of the process. The Court's Order also states that it intends that the Fund will pay "a reasonable amount of judgment interest" on the withheld amount, but the precise amount of interest payable will be determined by the Court at the conclusion of the claims administration process, and will be paid only if sufficient funds remain in the Fund.

An award of compensatory damages and prejudgment interest to a specific class member claimant will be reduced by: (1) a y% reduction and a z% hold-back reserve to ensure that sufficient funds will exist at the end of the claims administration process to fund all claims timely filed by Date f, and determined to be valid; (2) incentive awards to class representatives; and (3) class counsel attorneys' fees, costs, and expenses awarded by the Court.

If there is a surplus in the Fund after the z% reserve has been paid at the end of the claims administration process, an Additional Amount will be paid to each class member. The Additional Amount, if paid, consists of any net interest on the z% hold-back reserve not to exceed 3% per annum, non-compounded. Net interest is the sum of all interest earned on the Fund less certain costs of the Fund.

Each class member has signed a statement acknowledging, among other things, that class counsel provides representation to the class without any additional attorneys' fees

other than those that might be awarded by Court for the entirety of the work performed by class counsel for the class.

The Court may also provide for an incentive award to the class representatives in recognition of the services the class representatives provided to the class and the expenditures of time and money (including out-of-pocket costs and expenses) they incurred during the course of the class action litigation.

LAW AND ANALYSIS

Status as Qualified Settlement Fund

The Fund's first requested ruling is that the Fund is a qualified settlement fund under § 1.468B-1 for federal income tax purposes. Section 468B(g)(1) of the Code provides, in part, that nothing in any provision of law shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current income tax. Sections 1.468B-1 through 1.468B-5 of the regulations provide guidance regarding qualified settlement funds.

Section 1.468B-1(a) provides that a qualified settlement fund is a fund, account, or trust that satisfies all three requirements of § 1.468B-1(c). First, § 1.468B-1(c)(1) requires that the fund, account, or trust is established pursuant to an order of, or is approved by, the United States, any state (including the District of Columbia), territory, possession, or political subdivision thereof, or any agency or instrumentality (including a court of law) of any of the foregoing and is subject to the continued jurisdiction of that governmental authority. Second, § 1.468B-1(c)(2) requires that the fund, account, or trust is established to resolve or satisfy one or more contested or uncontested claims that have resulted or may result from an event (or related series of events) that has occurred and that has given rise to at least one claim asserting liability (i) under the Comprehensive Environmental Response, Compensation and Liability Act of 1980; (ii) arising out of a tort, breach of contract, or violation of law; or (iii) designated by the Commissioner in a revenue ruling or revenue procedure. Third, § 1.468B-1(c)(3) provides that the fund, account, or trust must be a trust under applicable state law, or its assets must be otherwise segregated from other assets of the transferor (and related persons).

Section 1.468B-1(h)(2) provides that if a fund, account, or trust is established to resolve or satisfy claims described in § 1.468B-1(c)(2) as well as other types of claims (i.e., non-allowable claims) arising from the same event or related series of events, the fund is a qualified settlement fund.

Based on the facts presented, the three requirements of § 1.468B-1(c) are satisfied and, as such, the Fund is a qualified settlement fund for federal income tax purposes. First,

the Fund has been approved pursuant to an order of the Court dated Date g, over which the Court retains jurisdiction during the Fund's complete administration. See § 1.468B-1(c)(1). Second, the Fund was established to resolve or satisfy claims brought by the class against W for damages sustained as a result of W's alleged breach of contract. See § 1.468B-1(c)(2). Third, the Fund is maintained in a separate and completely unrelated account in the dominion and control of the X and, as such, is segregated from other assets of W. See § 1.468B-1(c)(3). Finally, the fact that other claims may be paid by the Fund does not prevent the Fund from being treated as a qualified settlement fund. See § 1.468B-1(h)(2).

Modified Gross Income

The Fund's second requested ruling is that the Fund's modified gross income does not include prejudgment interest. Section 1.468B-2(b) provides that the modified gross income of a qualified settlement fund is its gross income, as defined in § 61, computed with certain modifications. Under § 1.468B-2(b)(1), amounts transferred to the qualified settlement fund by, or on behalf of, a transferor to resolve or satisfy a liability for which the fund is established are excluded from the gross income of the fund. However, payments in compensation for late or delayed transfers are not excluded from gross income.

Based on the facts presented, the prejudgment interest is excluded from the modified gross income of the Fund under § 1.468B-2(b)(1). W's payment to the Fund was not due until Date i. Prejudgment interest, awarded by the Court after trial, ceased to accrue on Date j, a date before Date i. Therefore, the prejudgment interest is an amount transferred to the Fund by W to resolve or satisfy a liability for which the Fund was established, and is not a payment in compensation for late or delayed transfers. See § 1.468B-2(n)(Ex. 1).

Deductions from Modified Gross Income

The Fund's third requested ruling is that the Fund is allowed a deduction in computing its modified gross income for costs of States' Counsel, X, and the Special Master. Section 1.468B-2(b)(2) provides that a qualified settlement fund is allowed a deduction from its modified gross income for administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund that would be deductible under chapter 1 of the Internal Revenue Code in determining the taxable income of a corporation. Administrative costs and other incidental expenses include state and local taxes, legal, accounting, and actuarial fees relating to the operating of the qualified settlement fund, and expenses arising from the notification of claimants and the processing of their claims. Administrative costs do not include legal fees incurred by, or on behalf of, claimants. See *also* § 1.468B-2(d) (amounts that are

distributed by a qualified settlement fund to, or on behalf of, a claimant are not deductible by the Fund).

The preambles to the proposed and final regulations under § 468B each indicate that the deduction from modified gross income allowed to a qualified settlement fund under § 1.468B-2(b)(2) for administrative costs and other incidental expenses is limited solely to those expenses related to the operation of the fund. See IA-54-90, 1992-1 C.B. 1103 (proposed); T.D. 8459, 1993-1 C.B. 68 (final). Commentators requested that the regulations specify that all expenses incurred in operating a trade or business be allowed as a deduction to a qualified settlement fund, but this suggestion was rejected as inconsistent with the general nature of such funds. Requests also were made to allow for the deductibility of claimant's legal expenses. However, the suggested change was not adopted since such payments are properly viewed as distributions to claimants. T.D. 8459, 1993-1 C.B. 68, 71. The list of expenses provided as examples of deductible administrative costs of a qualified settlement fund in § 1.468B-2(b)(2) – taxes, legal, accounting, and appraisal fees, and claimant notification expenses – are expenses which are ordinary operating expenses of a qualified settlement fund.

The Fund's expenses for X and the Special Master are administrative costs incurred in connection with the operation of the Fund. Accordingly, to the extent these expenses are deductible under chapter 1 of the Code in determining the taxable income of a corporation, these expenses may be deducted in computing the Fund's modified gross income under § 1.468B-2(a).

The individual States have been involved in this litigation in varying capacities. Several states have filed claims on their own behalf and on behalf of class members who failed to file claims during the claims administration process. Under the various states' abandoned property laws, amounts not claimed by class members during the class administration process will be held by the States for the benefit of the rightful owners of the funds. Attorneys' fees paid by the Fund to States' Counsel are, therefore, properly viewed as being in the nature of distributions to the claimants. See T.D. 8459, 1993-1 C.B. 68, 71. As such, these amounts are not administrative costs of the Fund incurred in connection with the operation of Fund and are not deductible in computing the Fund's modified gross income. See § 1.468B-2(d).

Interest on Class Counsel Attorneys' Fees

The Fund's fourth requested ruling is that the Fund is allowed a deduction in computing its modified gross income for the Class Counsel Interest under § 1.468B-2(b)(2). As noted above, § 1.468B-2(b)(2) allows a qualified settlement fund to deduct from its modified gross income certain administrative costs and other incidental expenses incurred in connection with the operation of the qualified settlement fund. In contrast, distributions to or on behalf of claimants are not deductible by a qualified settlement fund. See § 1.468B-2(d).

Class Counsel's participation in the litigation is provided on behalf of the class member claimants. Amounts paid to claimants' counsel are not deductible. See § 1.468B-2(b)(2) and (d). Similar to the attorneys' fees paid by the Fund to States' Counsel, payment of the Class Counsel Interest is properly viewed as being in the nature of a distribution to the claimants, and not a cost incurred for the benefit of the Fund. Therefore, the Class Counsel Interest is not an administrative cost of the Fund incurred in connection with the operation of the Fund and is not deductible in computing the Fund's modified gross income. See § 1.468B-2(d).

Interest on Hold-Back Reserve

The Fund's fifth requested ruling is that the Fund is allowed a deduction in computing its modified gross income for the Additional Amount under § 1.468B-2(b)(2).

The Additional Amount, if paid, represents a distribution by the Fund to claimants of interest on the z% of each claim that is withheld at the time of initial payment of a claim. The Additional Amount represents a potential enhancement of a class member's claim resulting from the deferral of payment of a claim, and is not an administrative cost of the Fund incurred in connection with the operation of the Fund. As such, the Additional Amount, if paid, is a distribution to a claimant that is not deductible in computing the Fund's modified gross income. See § 1.468B-2(d).

Information Reporting for Class Counsel Attorneys' Fees

The Fund's sixth requested ruling is that the Fund does not have a reporting obligation under § 6041 to class members for attorneys' fees, costs and expenses, and Class Counsel Interest awarded by the Court to class counsel. Section 1.468B-2(l)(2)(i) provides that payments and distributions by a qualified settlement fund are subject to the information reporting requirements in §§ 6031 through 6060.

Section 1.468B-2(l)(2)(ii)(A) provides, in part, that a qualified settlement fund must make information returns for a distribution to a claimant if one or more transferors would have been required to make a return had that transferor made the distribution directly to the claimant.

Section 1.468B-2(l)(2)(ii)(C) provides, in part, that for purposes of § 6041(a), if a qualified settlement fund makes a payment or distribution on behalf of a transferor or a claimant, the fund is deemed to make the payment or distribution to the recipient of that payment or distribution in the course of a trade or business.

Section 6041 requires all persons engaged in a trade or business and making payment in the course of such trade or business to another person, of rent, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or

determinable gains, profits, and income of \$600 or more in any taxable year, to file an information return with the Service and to furnish an information statement to the payee.

The word “income” as used in § 6041 is not defined by statute or regulation; however, its appearance in the phrase “fixed or determinable gains, profits, and income” indicates that what is referred to is “gross income,” and not the gross amount paid. Thus, in the present case, § 6041 requires the Fund to report only those payments in excess of \$600 includible in a class members’ gross income under § 61.

Section 61 provides generally that, except as otherwise provided by law, gross income includes all income from whatever source derived. The concept of gross income encompasses accessions to wealth, clearly realized, over which taxpayers have complete dominion. Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955). When a payment is made to satisfy the obligation of a taxpayer to a third party, the amount of the payment is generally includible in the taxpayer’s gross income. Old Colony Trust v. Commissioner, 279 U.S. 716 (1929). Even though the taxpayer never actually receives such payment, the taxpayer receives the benefit of the payment, and the amount is therefore gross income. Under the rationale of Old Colony Trust, a prevailing litigant must generally recognize gross income when another party pays attorneys’ fees for which the litigant is liable.

The rationale of Old Colony Trust is not applicable in certain opt-out class action lawsuits where, although the class members may receive a benefit from the litigation, no express contractual liability for a fee exists between the class members and litigating counsel. In such cases where there is no contractual agreement and someone other than the class members is liable for payment of attorneys’ fees incurred in connection with such litigation, the attorneys’ fees are generally not includible in a class member’s gross income.

In Rev. Rul. 80-364, 1980-2 C.B. 294, Situation 3, a union filed claims on behalf of its members against a company due to breach of a collective bargaining agreement. Subsequently, the union and the company entered into a settlement agreement, later approved by a federal district court, providing that the company would pay the union 40x dollars in full settlement of all claims. The union paid 6x dollars of the settlement for attorney’s fees and returned 34x dollars to the employees for back pay owed to them. The ruling concluded that the portion of the settlement paid by the union for attorney’s fees was a reimbursement for expenses incurred by the union and was not includible in the gross income of the union members. *But cf.* Sinyard v. Commissioner, T.C. Memo. 1998-364, *aff’d*, 268 F.3d 756 (9th Cir. 2001), *cert. denied sub nom*, Sinyard v. Rossotti, 536 U.S. 904 (2002) (holding that attorney’s fees recovered in an opt-in class action pursuant to Age Discrimination in Employment Act are includible in the gross income of a class member who had a contingency fee agreement with class counsel); and Fredrickson v. Commissioner, T.C. Memo. 1997-125, *aff’d in unpub. opinion*, 166 F.3d 342 (9th Cir. 1998) (holding that a class member’s gross income includes attorney’s fees

awarded in Title VII (opt-out) class action where class member personally signed a settlement agreement providing for compensation of counsel).

In the instant case, attorneys' fees will not be awarded or paid to class counsel pursuant to any specific fee or retainer agreement between such counsel and the class members, including the class representatives. No provision of the statement signed by each class member imposes an obligation on any class member to compensate Class Counsel for services rendered to the class. Rather, the attorneys' fees were, or will be, paid by the Fund to Class Counsel in an amount approved by the Court under the Settlement Agreement. Because the action was certified a class-action lawsuit, no separate agreements remained or became operative, and no amounts of attorneys' fees will be paid pursuant to any separate contingency fee or retainer agreement with a class member or class representative. Thus, the payment of attorneys' fees to class counsel by the Fund is similar to Situation 3 in Rev. Rul. 80-364 and does not constitute income to the respective class members or the class representatives.

Based on the facts presented, because the amounts paid by the Fund to class counsel for attorneys' fees, costs and expenses, and Class Counsel Interest, are not income to the class members or the class representatives, the Fund does not have a reporting obligation under § 6041 to class members for attorneys' fees, costs and expenses, and Class Counsel Interest awarded by the Court to class counsel.

Information Reporting for Incentive Award to Class Representatives

The Fund's seventh requested ruling is that the Fund does not have a reporting obligation under § 6041 to class members other than class representatives for incentive payment awards made by the Court to class representatives. The Settlement Agreement provides for incentive payments to the class representatives. The incentive awards are intended to compensate the named plaintiffs for the personal risk (if any) incurred by the plaintiffs in becoming and continuing as litigants and the time, effort and money expended in assisting in the prosecution of the litigation. Although their presence and efforts benefited the class as a whole, the incentive payments represent the added value the class representatives bring to the litigation and to the ultimate recovery. In re Continental Illinois Sec. Litig., 962 F.2d 566, 571 (7th Cir. 1992). Accordingly, the incentive payments belong solely to and are includible in the gross income of the class representatives only. See Berst v. Commissioner, T.C. Memo. 1997-137 (requiring named representative in a class action to include incentive payment in gross income).

Therefore, because a payment of an incentive award to class representatives is not gross income to other class members, the Fund does not have a reporting obligation under § 6041 to class members other than class representatives for incentive payment awards made to class representatives.

Information Reporting for Compensatory Damages and Incentive Awards

The Fund's eighth requested ruling is that the Fund does not have a reporting obligation under § 6041 to class members for payments to class members that are allocable to compensatory damages or for payments made to class representatives that are allocable to an incentive award. In general, any accession to wealth is presumed to be gross income unless the taxpayer can demonstrate that the accession fits into one of the exclusions created by other sections of the Code. Glenshaw Glass Co., 348 U.S. at 431; United States v. Burke, 504 U.S. 229, 233 (1992). The compensatory damages in this case constitute a clear accession to the wealth of the class members and no other section of the Code excludes such payments from gross income. Similarly, an incentive award is a clear accession to wealth of the recipient class representatives. Accordingly, the compensatory damages approved by the court in this case constitute gross income to the class members, and an incentive award constitutes gross income to a class representative.

As discussed above, § 6041(a) generally applies to payments of fixed or determinable gains, profits, and income of \$600 or more in any taxable year, and "income" in § 6041 refers to gross income within the meaning of § 61. Section 1.6041-1(c) provides that payments are fixed when they are paid in amounts definitely predetermined. Income is determinable whenever there is a basis of calculation by which the amount to be paid may be ascertained. Where the determination of the recipient's gross income inclusion of an amount is based on the knowledge of the recipient's basis and the payor lacks such information, the amount to be paid is not a payment of fixed or determinable amount of gains, profits, or income. See, e.g., Rev. Rul. 80-22, 1980-1 C.B. 286 (payment of insurance proceeds not a payment of a fixed or determinable amount of gains, profits, or income, where the determination of the recipients gross income inclusion of the insurance proceeds is based on the knowledge of the recipient's basis and the insurance company lacks such information). In addition, § 111(a) provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce the amount of federal income tax imposed.

Based on the facts presented, the Fund does not have a reporting obligation with respect to payments it makes to the class members that are allocable to compensatory damages. Payments from the Fund to class members allocable to compensatory damages are not payments of rent, salaries, wages, premiums, annuities, compensation, remunerations, or emoluments. Moreover, payments from the Fund to class members allocable to compensatory damages are not payments of fixed or determinable gains, profits, or income of \$600 or more. In this case, a class member's costs of acquiring Product a may have been deducted by the class member in a prior taxable year or may have been included in a class member's inventoriable costs. Payments from the Fund allocable to compensatory damages may be includible in the gross income of a class member to the extent that the class member derived any

federal income tax benefit from a previous deduction taken by the class member. However, the Fund is unaware of whether a class member took a deduction in a previous year and the amount by which such a deduction reduced the class member's federal income tax liability. See § 111(a). In addition, the Fund is unaware of how class members accounted for Product a for inventory purposes. Thus, the Fund is unable to determine if a payment from the Fund to a class member allocable to compensatory damages is includible in the gross income of the class member and the amount of the gross income inclusion, if any.

Similarly, based on the facts presented, the Fund does not have a reporting obligation with respect to incentive award payments it makes to the class representatives. Payments from the Fund to class representatives allocable to an incentive award are not payments of rent, salaries, wages, premiums, annuities, compensation, remunerations, or emoluments. Moreover, payments from the Fund to class representatives allocable to an incentive award are not payments of fixed or determinable gains, profits, or income of \$600 or more. In this case, incentive awards may be awarded by the Court to class representatives to, in part, compensate a class representative for out-of-pocket costs and expenses incurred during the course of the class action litigation. The Fund does not know the amount of expenses incurred by any class representative or how such expenses may have been accounted for by a class representative for federal income tax purposes. As a result, the Fund is unable to determine if an incentive payment award made to a class representative is includible in the gross income of the class member and the amount of the gross income inclusion, if any.

We express no opinion regarding whether payments of prejudgment interest or the Additional Amount, if any, are reportable to class members by the Fund.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representatives.

Sincerely,

John P. Moriarty
Senior Technician Reviewer, Branch 7
(Income Tax & Accounting)